Supreme Court, U. S.
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IN THE

Supreme Court of the United States

October Term, 1975.

No. 75-92

ROBERT W. TUNNELL and EOLYNE K. TUNNELL,
Petitioners,

v.

UNITED STATES OF AMERICA,
Respondent.

JAMES M. TUNNELL, JR. and MILDRED S. TUNNELL,
Petitioners,

v.

UNITED STATES OF AMERICA,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT.

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PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT.

Petitioners, James M. Tunnell, Jr., Mildred S. Tunnell, Robert W. Tunnell and Eolyne K. Tunnell, ask that a Writ of Certiorari issue to review the judgments of the United States Court of Appeals for the Third Circuit entered in its consolidated cases Nos. 74-1675 and 74-1678. The two cases are combined in this one petition as permitted by Rule 23.5 of this Court's rules.

OPINIONS BELOW.

The opinion of the District Court is reported at 367 F. Supp. 557, and the opinion of the Court of Appeals is reported at 512 F. 2d 1192, et seq. Copies of these opinions are appended (A1 and A21).

JURISDICTION.

The judgments of the Court of Appeals sought to be reviewed were dated and entered March 11, 1975, in both Nos. 74-1675 and 74-1678 (A27). Petitioners' timely motion for a rehearing was denied, and final judgments were entered on April 23, 1975 (A30). The jurisdiction to review these judgments by Writ of Certiorari is conferred upon this Court by 28 U. S. C. § 1254(1).

QUESTIONS PRESENTED.

I. Whether taxpayers who with a single capital expenditure create two assets, one depreciable and one non-depreciable, one a by-product of the other, must treat them as one asset and be limited to depreciation deductions taken on the total cost incurred less the sum it would have cost the taxpayers if they had needed and desired to create the non-depreciable asset separately.

II. Whether, assuming that it is correct to treat a non-depreciable asset as representing the "salvage value" of a separate depreciable asset, the amount of this "salvage value" should be measured by and equal to the cost of obtaining a similar asset at the time of the original acquisition.

STATUTE AND REGULATIONS INVOLVED.

The statute involved is Section 167(a) of the Internal Revenue Code of 1954, 26 U. S. C. § 167(a), which provides:

> "*Sec. 167. Depreciation*
>
> (a) *General Rule.* There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—
>
> (1) of property used in the trade or business, or
>
> (2) of property held for the production of income."

The regulations involved are Treas. Reg. §§ 1.167(a)-1(a), 1.167(a)-1(c)(1), and 1.167(a)-5, 26 CFR 1.167(a)-1(a), 1.167(a)-1(c), 1.167(a)-5 which provide, in pertinent part:

> "§ 1.167(a)-1(a). *Reasonable Allowance.*
>
> Section 167(a) provides that a reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in the trade or business or of property held by the taxpayer for the production of income shall be allowed as a depreciation deduction. The allowance is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan . . ., so that the aggregate of the amounts set aside, plus the salvage value, will, at the end of the estimated useful life of the depreciable property, equal the cost or other basis of the property. . . .

"§ 1.167(a)-1(c). *Salvage.*—(1).

Salvage value is the amount (determined at the time of acquisition) which is estimated will be realizable upon sale or other disposition of an asset when it is no longer useful in the taxpayer's trade or business or in the production of his income and is to be retired from service by the taxpayer. . . .

"§1.167(a)-5. *Apportionment of Basis.*

In the case of the acquisition on or after March 1, 1913, of a combination of depreciable and non-depreciable property for a lump sum, as for example, buildings and land, the basis for depreciation cannot exceed an amount which bears the same proportion to the lump sum as the value of the depreciable property at the time of acquisition bears to the value of the entire property at that time. . . ."

STATEMENT OF THE CASE.

1. The Facts.

The facts of this case are essentially as reported in the opinion of the District Court (367 F. Supp. 559-60; A2, *et seq.*), and the facts pertinent to the specific questions raised in this petition need only be stated briefly.

Petitioners, Eolyne K. and Robert W. Tunnell, and Mildred S. Tunnell and James M. Tunnell, Jr. (hereinafter referred to as "taxpayers") formed two partnerships to develop and operate two mobile home parks known as "Pot-Nets" and "Indian Landing" in Sussex County, Delaware. Both parks are situated on land which in its original state, was part marsh, part cultivated, and part forested. Low-lying marshes separated the wooded and cultivated areas from the open waters of Indian River Bay, and, being soft and wet, were unsuited for either buildings or roads. In order to construct the parks, taxpayers designed and excavated certain waterways, called "lagoons". These lagoons provide a safe harbor for recreational boats and a convenient docking place for those who reside in the parks and want their boats close to their homes. When bulkheaded, the lagoons are more appealing aesthetically than the marshes they replaced. The material dredged from the lagoons was, in time, able to be used as landfill in the remaining low lands.

The taxpayers capitalized the dredging costs for the lagoons ($104,819.00) and made deductions for depreciation in 1966, 1967 and 1968. As a result of an IRS audit, the taxpayers were notified in 1969 that these deductions would be disallowed, resulting in tax deficiencies for the years in question. The taxpayers under protest paid the taxes allegedly due plus interest and then instituted actions in the District Court, pursuant to 28 U. S. C. § 1346(a)(1), for a refund of the additional amounts so paid.

2. The Litigation.

In the District Court the government's case for disallowing the depreciation deductions was based upon two contentions. First, it was argued that the lagoons were an integral part of the land on which the properties are situated, and the expenditures thereon were not depreciable because land is incapable of wearing out. Second, it was contended that even if the lagoons were capable of wearing out, their limited lives are indeterminate so that no depreciation is allowable (367 F. Supp. 561; A6).

The taxpayers' arguments were three-fold. First, it was contended that the lagoons were features of a total complex which itself has a limited life, and that these components derive their expectancy of a useful business life from the limited life of the whole. Second, the taxpayers relied on IRS Depreciation Guidelines, Rev. Proc. 62-21, 1962-2 Cum. Bull. 418, which specify a depreciable life of twenty years for canals and waterways. Finally, the taxpayers offered proof that the lagoons were in fact physically wearing out over a reasonable predictable period, and should be depreciable over that period (367 F. Supp. 557; A6).

The District Court agreed with the taxpayers' first contention, equated the useful lives of the lagoons with the twenty-year useful lives of the parks, and allowed the taxpayers to depreciate the total cost of building the lagoons over the twenty-year period (367 F. Supp. 561-62; A8-A10).

The government, upon its appeal, conceded that the cost of building the lagoons was depreciable over the twenty year period set forth in its guidelines[1] (A23).

1. Indeed, in Rev. Rul. 75-137, IRB No. 1715-16, issued on April 21, 1975, the Service revised its prior position and ruled that the cost of such water canals is depreciable in all cases if the asset is actually exhausting and the exhaustion is susceptible to measurement. Clearly, the taxpayers should never have been forced to litigate this case at all.

However, for the first time in the action, the government proposed the novel theory that since the taxpayers had benefited by obtaining the fill dirt created by the dredging, the sum it would have cost the taxpayers to obtain such fill in some other way should be treated as "salvage value" of the lagoons and subtracted from the depreciable basis of the lagoons. The Court of Appeals, purporting to apply Treas. Reg. § 1.167(a)-1(a) and § 1.167(a)-1(c)(1) and this Court's decision in *Massey Motors v. United States*, 364 U. S. 92 (1960), accepted the government's theory and held:

> "We believe therefore, the proper amount recoverable by depreciation is the total cost of designing and constructing the lagoons less the sum it would have cost the taxpayers to obtain the necessary quantity of fill from their own property, if possible, or elsewhere to grade and convert the marshlands into suitable, dry land for the operation of mobile parks." (A29).

The case was remanded to the District Court to allow the taxpayers to present proof of the cost of the land fill, the Court of Appeals reasoning that it would be unfair to deny the taxpayers' refunds entirely for failure to present proof upon an issue that had never been raised before (A25-A26).

The taxpayers petitioned for a rehearing but, apart from an insubstantial change in the wording of the opinion, this petition was denied and final judgment entered April 23, 1975. This petition follows.

REASONS FOR GRANTING THE WRIT.

There are two questions presented in this petition, one dealing with the proper treatment of a single capital expenditure which produces both a depreciable and a non-depreciable asset, and one dealing with the proper definition of salvage value. However, since for purposes of this case the two questions are so completely interconnected, they will be treated together in the argument.

The Novel Approach of the Government and the Court Below Raises Substantial Questions in a Vital Area of the Internal Revenue Laws: We must start with the unquestioned proposition set forth in the opinion of the Court of Appeals (A24), that *two assets* were created as a result of the capital expenditures of taxpayers. As is now conceded by all parties, one of them (the lagoons) is depreciable and one of them (the fill) is non-depreciable. Such an occurrence is far from uncommon and until this case, the judicial and administrative solution to any problems of basis allocation has always been the same—equitable apportionment of the total cost between the depreciable and non-depreciable assets in proportion to the relative fair market values of each. This is the approach of the Treasury in its own Regulations dealing with the question, Tres. Reg. § 1.167(a)-5 (set forth at p. 4, *supra*), and of a number of revenue rulings and judicial opinions. See, e.g., Rev. Rul. 68-528, 1968-2 C. B. 331; *Reed A. Watkins, et al.*, ¶ 73,267 P-H Memo TC; *A. N. McQuown v. Commissioner*, ¶ 53,204 P-H Memo TC.

This approach has not only been applied in the classic case where the actual purchase price of non-depreciable land with a depreciable building upon it must be allocated between the two assets, but also in situations like the present one where expenditures are incurred for services that produce two different assets. For example, in Rev.

Rul. 68-528, *supra*, the taxpayer incurred legal expenses in connection with the purchase of real estate consisting of land and depreciable improvements. The Service held that the legal expenses were costs of acquiring both the land and the improvements and that the basis of each of the two assets had to reflect a ratable portion of those expenses. This was to be done "by allocating the expenses according to the respective fair market values of the land and the improvements at the time of purchase". For the purposes of the present question there is no real distinction between legal expenditures and dredging expenditures. Both are costs incurred for services which produce tangible assets, thus representing the cost basis of the assets. And, as demonstrated by the above ruling, when such services produce both a depreciable and a non-depreciable asset the policy has always been to allocate the cost between the two ratably.

The only arguably novel feature of the present case is that the value of the land fill (as the court below measures that value) may actually be equal to or even exceed the entire cost of the dredging. After all, the act of digging a hole and of piling up the dirt alongside is the same act. Thus, the cost of acquiring the dirt alone is as great as of acquiring the hole alone. If both the hole and the dirt have value, as in this case, there may be a bargain. However, when such a "bargain price" is obtained, the policy still has been to allocate the cost basis proportionately between the two assets, and not to allocate the entire cost to the non-depreciable asset. In *A. N. McQuown, supra*, the taxpayer obtained land and improvements having a total value of $35,000 for the bargain price of $21,000. The court found the land had a fair market value of $18,000 and the improvements $17,000, and using this ratio allocated $10,200 of the cost to the improvements and $10,800 to the land. Under the Third Circuit's decision which this

petition seeks to have reviewed, the land would have to be valued at $18,000 and the depreciable improvements $3,000.

Therefore, it is clear that the government's argument in this case, denominating one asset as "salvage value" of an entirely separate asset, is not only strange on its face, but contrary to previously unquestioned principles of tax law. The government's approach, in effect, results in allocating the cost of the two assets entirely to the non-depreciable asset. Since cases such as the present one are not uncommon, the effect is potentially far-reaching. There are artifically created ponds, lakes and lagoons throughout the land. Moreover, the Treasury Guidelines advising the public of the depreciability of artificial waterways created for business purposes (A32) are and will be affirmatively misleading. All excavations produced dirt, and wherever the excavated dirt may have some value, however small, the hypothetical cost of bringing in that dirt from some other place will probably wipe out the total supposed basis for depreciability and make the Guideline a snare instead of an aid.

Turning now to the second question presented by this Petition, even if we are to enter a never-never land where one asset is the salvage value of another, the Court of Appeals' definition of salvage value is in conflict with the law. This Court in *Massey Motors v. United States, supra,* defined salvage value as "estimated resale or second-hand value". This is in accord with Treas. Reg. § 1.167(a)-1(c), which defines salvage as "the amount realizable upon the sale or other disposition of an asset when it is no longer useful in the taxpayer's trade or business or in the production of income." The court below pays lip service to these fundamentals and then proceeds to define salvage value as the hypothetical cost of obtaining the fill by some other means at the time of the original excavation (A29).

Never before has salvage value been so measured or defined in this manner.

If this dirt is to be treated as salvage value of the lagoons, then according to all previously accepted tenets of law it must be valued at the end of the twenty-year life of the lagoons—in short, as dirt on the bank of worthless and unusable lagoons. If its resale value at that time is to be the measurement of salvage value, then the taxpayers should be permitted to subtract from this resale value the costs of removing the dirt for sale and also, arguably, the costs of converting the muck dredged from the marshes into usable fill dirt. These costs may even exceed the resale value of the dirt, thus resulting in "negative net salvage". See *Portland General Electric Company v. United States,* 223 F. Supp. 111, 112 (D. Oregon 1963).

Even if salvage value is measured as value at the time of acquisition, the Court of Appeals' approach would be improper. The opinion below equates the slime, muck and sand pumped out of the marshes with good, usable fill of such a character and condition that it could be transported to the marshes and spread thereon. Actually, the product of the excavations was of such a consistency and deposited in such wet, ungraded and undrained places that it could not be graded or in any manner made use of for periods up to three years after the excavation. This deprived the taxpayers of the use of their land and added large sums to the out-of-pocket costs of moving around and grading the material. However, these are questions of fact to be proved upon any necessary remand. At this point, the litigation has resolved itself into fundamental questions of law.

To summarize, the court below has rewritten the law relating to salvage value. First, it has ignored the accepted theory of equitable apportionment of basis when

two assets, one depreciable and one not, are acquired by the same expenditure. In so doing, it has adopted the unprecedented idea that one asset can be "salvage value" of another, separate asset. This approach simply results in allocating the entire cost of the expenditures to the non-depreciable asset, thus depriving the taxpayers of any opportunity to recover the cost of a concededly wasting asset. Secondly, the court in applying this theory has departed further from fundamentals by defining salvage value as value at the time of acquisition. This simply ignores the meaning of the word "salvage" and is, of course, inconsistent with previous decisions of this Court and the Treasury. Finally, the court has determined that "cost" is to be the measure of "salvage value", which is totally unrealistic, especially when applied to a by-product. The taxpayers are prepared to prove that economics are such that this particular non-depreciable asset would never be created separately, but only as a by-product. These novel and literally unprecedented theories, so novel that they were not even advanced by the government until the latter stages of this very litigation, create drastic departures from previously accepted principles.

CONCLUSION.

For the foregoing reasons, this Petition for Writ of Certiorari should be granted.

Respectfully submitted,

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APPENDIX.

ROBERT W. TUNNELL and EOLYNE K. TUNNELL,
Plaintiffs,

v.

UNITED STATES OF AMERICA,
Defendant.

JAMES M. TUNNELL, JR. and
MILDRED S. TUNNELL,
Plaintiffs,

v.

UNITED STATES OF AMERICA,
Defendant.

Civ. A. Nos. 4287, 4302.

United States District Court,
D. Delaware,

Nov. 28, 1973 (Reported 367 F. Supp. 557).

James M. Tunnell, Jr., Wilmington, Del., and Robert W. Tunnell, Georgetown, Del., pro se and as attorneys for the other plaintiffs.

Ralph F. Keil, U. S. Atty., Alan S. Yoffie, Asst. U. S. Atty., Wilmington, Del., and Michael von Mandel, Trial Atty., Tax Div., U. S. Dept. of Justice, Washington, D. C., of counsel, for defendant.

OPINION

LATCHUM, *Chief Judge.*

This consolidated action arises out of a dispute between the plaintiffs [1] and the Internal Revenue Service ("IRS") over the depreciability of certain expenditures which the plaintiffs capitalized in the development of two mobile home park ventures owned and operated by them as partners in Sussex County, Delaware.

As a result of an IRS audit, the plaintiffs were notified in 1969 by the IRS that adjustments were being made to the plaintiffs' partnership returns for 1966, 1967 and 1968 by disallowing certain deductions for depreciation and a deduction for an operating expense.[2] The adjustments so made in the partnership returns resulted in alleged individual income tax deficiencies to the plaintiffs, Robert and Eolyne Tunnell in C. A. No. 4287, for which they received a Statutory Notice Statement of additional income taxes due of $5,686.35 for 1966, $5,093.32 for 1967 and $6,864.25 for 1968.[3] The IRS adjustment in the partnership returns also resulted in alleged individual income tax deficiencies to the plaintiffs, James M. Tunnell, Jr. and Mildred S. Tunnell, for which they received a Statutory Notice Statement of additional income taxes due of $6,076.65 for 1966, $4,448.77 for 1967 and $9,209.65 for 1968.[4] In both cases the plaintiffs under protest paid the taxes allegedly due plus interest within the time required by law and then instituted these actions for a refund of the additional amounts so paid.[5] Jurisdiction exists by virtue of 28 U. S. C. § 1346(a)(1).

1. The plaintiffs in each Civil Action are husband and wife who filed joint income tax returns for the years in dispute.

2. Docket Item 1, Ex. A1 & A2 (C. A. 4287).

3. Docket Item 1, Ex. A4 (C. A. 4287); Pretrial Order par. (a).

4. Docket Item 1, Ex. 4 (C. A. 4302); Pretrial Order par. (a).

5. Docket Item 1, pars. 10-15 in (C. A. 4302 & C. A. 4287).

Before reaching the merits of this litigation a brief review of the facts giving rise to the dispute is in order. The plaintiffs in these refund suits formed partnerships to develop and operate two mobile home parks in Sussex County, Delaware known as "Pot-Nets" and "Indian Landing." Each plaintiff owns 25 per cent of the Pot-Nets partnership. With respect to Indian Landing each plaintiff in C. A. 4302 owns 25 per cent of the partnership, while plaintiff Robert Tunnell in C. A. 4287 owns the remaining 50 per cent.

Lots in both parks are leased to third parties on long term leases [6] for the purpose of allowing these third parties to place mobile homes thereon which are used as weekend and vacation homes by the tenants.[7]

Both mobile home parks are situated on land which in its original state was part forested, in part cultivated fields and in part marshland.[8] The wooded and cultivated areas of the high land were separated from the open waters of Indian River Bay by low-lying marshes.[9] Because the marshland was soft and tended to be wet, it was totally unsuited for either building or travel. Hence the taxpayers caused to be designed and excavated certain waterways, called lagoons, which are simply canals.[10]

The lagoons or canals were erected for several purposes. They provide a safe harbor for recreational boats and make a ready and convenient place ashore for those

6. The original leases at Pot-Nets were permanent leases but for the past four years are 20 year leases, while the leases at Indian Landing are for 10 years. These leases may be broken by the tenant without cause but can be cancelled by the owners only with cause. (Trial Record—"Tr." 12, 87, 105).

7. Tr. 261.

8. Px. 1, Px. 12, Tr. 8, 110.

9. Id.

10. Tr. 25-27, 30, 64, 112, 185.

who reside in the projects and want their boats close to their homes. The lagoons when bulkheaded, are more appealing esthetically than the marshes they replaced. The material dredged from the lagoons was also used as fill behind the bulkheads on the remaining low lands upon which roads, recreational, playground and, in some instances, living areas could be placed. The lagoons or canals also serve to provide surface water drainage for the necessarily flat and low terrain on which the projects were located.[11]

In order to make the wooded areas suitable for use, portions of it were thinned while the remainder was completely cleared.[12] Thereafter all of the solid land areas were graded, shaped and landscaped to be used as mobile home lot sites and recreational areas.[13]

When completed, the parks featured mobile home sites, private roads, street lights, water and electricity lines, shrubbery and landscaping, playground areas for children, shuffleboard courts, miniature golf courses and other recreational facilities.[14] The plaintiffs also provided a central TV tower for the tenants at Indian Landing, and a swimming pool for the tenants at Pot-Nets.[15]

On the partnership tax returns for Pot-Nets in the years in dispute 1966 through 1968,[16] the plaintiffs attempted to capitalize all their expenditures and to claim a depreciation allowance. The IRS allowed depreciation on all expenditures except those labeled "lagoons" and those labeled "land improvements." "Lagoon" expenditures consisted of the initial dredging expenses while "land

11. Tr. 15-17, 26.
12. Tr. 73-74, 107.
13. Tr. 18, 135, 137.
14. Tr. 105-106.
15. Tr. 12-13; 106.
16. Dx. 1.

improvements" consisted of the expenses of surveying, clearing or thinning wooded areas, bulldozing and grading solid land areas, and shrubbery and landscaping. The plaintiffs had claimed a ten year useful life for the "lagoons" and a twenty year useful life for "land improvements." Another item disallowed by the IRS from the 1966 Pot-Nets return was an expenditure of $6,819.23 for bulldozing, land clearing and hauling claimed by the plaintiffs to be an operating expense.[17]

Similarly, with respect to the Indian Landing partnership tax returns, the IRS refused to allow depreciation on the same type of expenditures.

As previously noted the net effect of the above disallowances was to decrease the amount of partnership loss for each plaintiff and in turn increase each individual's taxable income.

Trial in the instant cases was held on June 6 and 7, 1973. Since post-trial briefing has been completed the matter is now ripe for decision.

26 U. S. C. § 167 provides:

> "(a) General rule.—There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—
>
> (1) of property used in the trade or business, or
>
> (2) of property held for the production of income."

Differing interpretations of this deceptively simple provision of the Internal Revenue Code are the basis of the controversy presently before the Court. The Govern-

17. The plaintiffs now seek to have this item treated as a depreciable capital expenditure.

ment contends that the lagoons and land improvements are an integral part of the land on which the mobile home parks are situated, and therefore the expenditures thereon are not depreciable because land is incapable of wearing out, becoming obsolete, or reverting to marshland. The Government also contends that even if the lagoons are capable of wearing out, their limited lives are indeterminate so that no depreciation is allowable.

The plaintiffs contend first that the lagoons and land improvements are features of a total complex which itself has a limited life, so that these components of the whole derive their expectancy of a useful business life from the limited life of the whole. The plaintiffs contend second that the Government is estopped from asserting the non-depreciability of the expenditures because certain Guidelines for Depreciation (Revenue Ruling 62-21)[18] published by the IRS led them to believe prior to undertaking the projects that all the expenditures in dispute were depreciable. That plaintiffs also contend with respect to the lagoons that they are physically wearing out over a reasonably predictable period, and therefore should be depreciable over that period.

The Court will first deal with the lagoons expenditures. This Court holds that the lagoons are assets susceptible to depreciation. The value of the lagoons is in large part related to their role as an attractive feature of a waterfront mobile home park. As discussed above, the lagoons were designed to provide a safe haven for the boats of tenants, to provide a waterway for ingress and egress to Indian River Bay for boat owning tenants, and to provide surface water drainage for the parks. It goes without saying that the lagoons will be useful for those purposes only as long as the projects exist. When the

18 Px. 21.

mobile home projects become obsolete, the lagoons, which are an integral part of the projects, also become obsolete. Norfolk Shipbuilding & Drydock Corp. v. United States, 321 F. Supp. 222, 227 (E. D. Va. 1971). Therefore the useful lives of the lagoons do not exceed the useful lives of the projects so that the initial costs of dredging the lagoons may be depreciated over the useful lives of the projects.

The Government argues that the useful lives of the lagoons will continue indefinitely since they could serve other uses after the projects become obsolete, and since the useful lives of the lagoons are indeterminate, no depreciation on them may be allowed. This position is inconsistent with the IRS' own regulations however. 26 CFR § 1.167(a)-1(b) provides:

> "For the purpose of section 167 the estimated useful life of an asset is not necessarily the useful life inherent in the asset but is the period over which the asset may reasonably be expected to be useful to the taxpayer in *his* trade or business or in the production of *his* income." (Emphasis added).

While conceivably the lagoons could serve some other use after the mobile home parks become obsolete, this possible use is irrelevant to a determination of their useful lives for purposes of depreciation allowance. See Southern Natural Gas Company v. United States, 412 F. 2d 1222, 1233, 188 Ct. Cl. 302 (1969). The plaintiffs are not in another business, they are in the business of owning and operating a mobile home park and when the useful lives of the projects terminate after twenty years (a period allowed by the IRS),[19] the useful lives of the lagoons will also be deemed to have ended for tax purposes.

19. Docket Item 19, pars. 7 and 12; Tr. 155-157.

Moreover private roads have been treated as tangible additions distinct from the underlying land which are depreciable over their useful lives. Rev. Rul. 65-265; Aurora Village Shopping Center, Inc., 29 TCM 126 (1970); D. Loveman & Sons Export Corp., 34 T. C. 776 (1960), aff'd per curiam, 296 F. 2d 732 (C. A. 6, 1961), cert. den., 369 U. S. 860, 82 S. C 950, 8 L. Ed. 2d 18 (1962); Clinton Cotton Mills v. Commissioner, 78 F. 2d 292 (C. A. 4, 1935). The Court can perceive no sound basis in logic for treating the lagoons differently with respect to depreciability. They appear similar in the following respects: Both roads and lagoons serve a useful purpose in providing ingress and egress to a given project. In both instances their useful lives are peculiarly tied to the useful lives of the entire project to which they provide access since without the existence of the project, there would be little reason to use the access facilities. Thus roads and lagoons would both be virtually worthless without the existence of the project. *Norfolk Shipbuilding & Drydock*, supra, 321 F. Supp. at 227. Just as the costs of building a road for land traffic include the expenses of clearing and grading the underlying land, so also the costs of creating a lagoon to facilitate marine traffic include the expenses of dredging to a sufficient depth. Also just as the physical life of a road may be increased by covering its surface with a more permanent material such as cement or blacktop, similarly the physical life of a lagoon may be increased by bulkheading its sides. Since the uses and expenses of the waterways and roads appear closely analogous, the Court holds that as to depreciability they should be treated similarly.

With respect to the lagoons at Pot-Nets, the plaintiffs estimated on their tax returns their useful lives at ten years, while the bulkheads, boat slips, docks and moorings were estimated to have a useful life of twenty years.[20] While the

20. Tr. 155.

Court previously observed that the useful life of the lagoons would not be longer than the useful life of the entire Pot-Nets project, it conceivably could be shorter in the event that the lagoons physically wear out in a shorter period of time than the other components of the project.

Toward that end, the plaintiffs have introduced evidence of surveys done by themselves to determine the rate at which the lagoons are filling up by erosion and silting.[21] Calculations based on the survey data estimate the useful life of the lagoons at Pot-Nets as 13.22 years,[22] after which time large pleasure craft will no longer be able to use them.[23] However, the plaintiffs did admit that their measurements were not made with scientific precision[24] and they admitted that the filling-in may not continue at its past rate.[25] In order to claim a swifter depreciation rate the plaintiffs have the burden of proving that the lagoons will physically wear out before the remainder of the project is obsolete. Cf. Psaty v. United States, 442 F. 2d 1154 (C. A. 3, 1971). The plaintiffs have not met their burden of proving that the useful life of the Pot-Nets lagoons is shorter than twenty years useful life assigned to the majority of the components of the project, and depreciation should be allowed on the basis of a twenty year useful life. Since the lagoons at Indian Landing were assigned a useful life of twenty years, the useful life assigned to the entire project, no adjustment need be made.

21. Tr. 38-41; 82.

22. Tr. 42.

23. Since the banks of the lagoons in many instances are leased to and occupied by tenants who installed mobile homes and made other improvements to their lots, the plaintiffs lack access to the banks and cannot conduct operations to reverse the filling-in effect either by dredge or by dragline. Tr. 52, 113, 126, 256.

24. Tr. 244.

25. Id.

Turning now to the land improvement costs, the plaintiffs argue that all these expenditures in dispute, primarily clearing, grading and landscaping costs, should be considered to be part of the cost of creating waterfront mobile home park projects and therefore depreciable over the useful lives of the projects. The Government argues that all the expenditures in dispute resulted in improvements to the underlying land, and since the improved land is incapable of physically wearing out or becoming obsolete, the costs of improving the land are not depreciable.

The Court is unable to agree with either position. Land improvement expenditures which increase the value of the land without regard to the particular use made of the land must be regarded as a cost of improving the land and not a cost of the project as the plaintiffs contend. As the Government asserts, since the improved land will not physically wear out [26] or become obsolete, the costs of improving the land itself are not depreciable. However, contrary to the Government's assertion, not all of the expenditures in dispute increased the value of the land *per se*. Some of the expenditures in dispute are attributable to components of the projects which will become worthless when the projects cease to exist. These latter expenditures will be considered part of the costs of creating waterfront mobile home park projects rather than expenditures relating to improving the land itself and are depreciable over the useful lives of the projects.

The plaintiffs, in support of their position that all the disputed expenses are depreciable, rely on Trailmont Park, Inc., 30 TCM 871 (1971), a memorandum Tax Court opinion which permitted depreciation on all the costs of clearing, grading, terracing and landscaping land in creating a mobile home park. However, there none of the expenditures improved the land generally by inherently increasing its value, but only facilitated the construction of the park. The underlying land involved there was a mountainside upon which several levels of terraces were landscaped to hold trailer pads. The resultant land configuration was useable only to support a mobile home park. The Tax Court observed that any other use of the land would require complete reshaping of it, 30 TCM at 873, and therefore all of the clearing, grading, terracing and landscaping expenditures would lose their value upon cessation of the mobile home park. Thus, the expenditures were inextricably associated with the mobile home park and not with the underlying land. In contrast in the instant situation, some of the expenditures resulted in an increase in the value of the land *per se*.

The Court will now apply this general rule to the types of expenditures in dispute. One of the major expenditures was for clearing or thinning wooded areas. The Court holds that these expenditures did not increase the value of the land *per se*. The clearing had to be done in a pattern peculiar to the creation of a mobile home park. The plot plans [27] and photographs [28] show a veritable honeycomb of small, tree-shaded lots and roads. Apparently, on each lot some trees were left standing, but a swath was cut through them wide enough to permit a trailer to be placed on the land. Because of the present use of the land, the configuration of trees and cleared area is in a unique pattern, and were the land to be put to any other use, most of the trees now left standing might have to be felled, so that what was originally a wooded area would become essentially treeless. The Court takes judi-

26. Although the plaintiffs asserted that the land would ultimately return to its former state, no evidence was introduced estimating the duration of the land in its present improved state.

27. Px. 3, Px. 14.

28. Px. 15-I; Px. 9-A; Px. 7-6.

cial notice that in today's market cleared land often has a lower value for residential purposes than it would have if it were still wooded, and it cannot be said that the clearing of wooded areas that was accomplished in the instant case to prepare the land for use as a mobile home park increased the value of the land *per se*. Thus the clearing and thinning expenditures may be regarded as costs of creating the projects and may be depreciated over the useful lives of the projects.

An even stronger case is presented for the costs of landscaping. Were the land put to any other use, existing lots and streets would have to be obliterated and all landscaping would need to be redone. Thus, landscaping expenditures may be considered a cost of creating the projects and may be depreciated over the useful lives of the projects.

However, as for grading expenses, it would appear that most of the grading expenses increased the value of the land *per se*. It is fair to say that for most purposes, graded dry land would have a greater value than marshland. Thus, the expenditures for grading the land will be considered a non-depreciable expenditure of improving the land itself, except for that portion of the grading expenditures which are attributable to the creation of some feature which is depreciable over the useful lives of the mobile home parks, as for example, the private roads which spread throughout both projects.

Having commented on the depreciability or non-depreciability of the general categories of expenditures involved, the Court will consider the question of the depreciability of each expenditure in dispute as listed on plaintiffs' exhibits 10 and 11.

In dispute in all three years with regard to Pot-Nets and Indian Landing are payments to the Melvin L. Joseph

Construction Company which the plaintiffs attempted to capitalize. The payments for work at Pot-Nets amounted to $14,251.18 in 1966, $1,664.76 in 1967 and $2,539.50 in 1968. The payments for work at Indian Landing amounted to $7,851.70 in 1966, $8,510.84 in 1967 and $3,751.27 in 1968. Apparently these expenditures involved bulldozing trees, building roads and general grading.[29] As the Court discussed previously, the costs of clearing trees and building roads are depreciable, while general grading expenditures are not. However, the plaintiffs did not establish which portion of the expenditures went into activities for which depreciation may be allowed. Since they have the burden of proving that the Government's assessment against them was erroneous, Psaty v. United States, supra, 442 F. 2d at 1158, they have the burden of proving that portion of each expenditure which may be depreciated. Having failed to meet their burden of proof on these expenditures, they will not be allowed to depreciate them.

There were payments to Wingate & Eschenbach, a civil engineering firm for work at Pot-Nets in the amount of $1,771.85 in 1966 and $876.20 in 1967. The work performed was designing and laying out lagoons and staking out mobile home lots.[30] Since the Court has held that lagoons are depreciable, the costs of designing them are also depreciable. The boundaries of the mobile home lots will be valueless when the projects cease to exist so that the cost of establishing the boundaries is depreciable over the useful life of the projects. Therefore all of the payments to Wingate & Eschenbach may be depreciated.

Payments to Van Demark & Lynch, Inc., another engineering firm, for similar services performed at Indian

29. Tr. 148.
30. Tr. 72-73.

Landing [31] in the amounts of $4,837.60 in 1966, $3,507.25 in 1967, and $1,177.50 in 1968 may likewise be depreciated.

The remaining "land improvement" expenditures at Pot-Nets for land improvements were $397.63 paid to Indian Landing for digging and $364.00 to Kackle Farm, apparently for bulldozing. Since neither of these expenditures were proven to be attributable to depreciable features of the project, no depreciation will be allowed.

The dredging costs for the lagoons at Pot-Nets amounting to $25,500.00 paid to Breakwater Dredging Co. in 1967 may be depreciated; in the same vein $79,319.00 for dredging the lagoons at Indian Landing paid to Cottrell Engineering in 1966 is depreciable.

The following "land improvement" payments made on behalf of Indian Landing are depreciable because their value is tied to the useful life of the project: $455.00 to the Mobile Home Manufacturers Association in 1966 for designing lot sizes; [32] $25.00 in 1966 for aerial photos; $217.20 to Joseph Forst in 1967 for markers for lot corners; [33] $206.35 to Graves Block & Supply Co. in 1967 for concrete squares to cover water valves; [34] $155.00 to Don Penuel & Lankford Sign Co. in 1967; $92.19 to Delaware Electric Cooperative, Inc. in 1967; $45.00 to Thoro-Good Concrete Co. in 1968; and $82.50 to Seaboard Lumber Co. in 1968.

The following "land improvement" payments made on behalf of Indian Landing are not depreciable: $316.38 to James Blackwell in 1966 for land clearing; [35] $650.00 to Richard M. Calhoun in 1967; $88.50 to Harold L. Johnson in 1967; and $100.25 to Kackle Farms in 1968.

31. Tr. 148.
32. Tr. 137.
33. Tr. 149.
34. Id.
35. Tr. 109.

Of the $6,819.34 item originally listed as a maintenance expense of Pot-Nets now sought to be treated as a capital expenditure, $3,422.00 paid to the Melvin L. Joseph Construction Corp. was proved to be attributable to building roads and may be depreciated.[36] Of the remainder, $2,976.95 [37] appears to have gone to hand clearing of woods that had become overgrown during a period of neglect after it had been bulldozed. Since what apparently was removed was underbrush and not valuable trees, its removal would appear to increase the value of the land itself, and hence is not depreciable.[38] The remaining $420.39 was not accounted for and may not be depreciated.

The Court will now consider the remaining issue raised by the plaintiffs. The plaintiffs argue that the Government is estopped from asserting that the land improvement expenses are not depreciable. They claim that they entered into the ventures here involved only because they believed that all the expenses in dispute would be depreciable, and that their reliance was based upon certain Guidelines for Depreciation ("Guidelines") issued by the IRS in 1962,[39] which suggest a useful life of twenty years for canals, waterways, landscaping, shrubbery and similar improvements.[40] The plaintiffs argue that the Government is estopped from taking a position adverse to its earlier promulgated Guidelines.

36. Tr. 20, 23.
37. $1,679 went to James Blackwell and the remainder was in small payments to unnamed laborers in the amounts of $145.00, $161.46, $60.84, $223.30, $41.12, $79.78, $280.00, and $305.45. Tr. 24-25; 80.
38. The plaintiffs' original treatment of this amount as a current expense would appear to have been correct.
39. Revenue Ruling 62-21, Px. 21.
40. Px. 21, p. 11.

The Court does not agree. The Guidelines were designed to provide a businessman with a reasonable advance assurance of the useful life of a depreciable asset acceptable to the IRS. Stevens Realty Co. v. Commissioner, 276 TCM 528, 530 (1967). They were not intended to be a dispositive statement that the assets listed would be depreciable in every instance. In fact, the Guidelines state that the depreciation schedule has no relevance to whether a particular expenditure can be treated as a capital expenditure recoverable through depreciation.[41] Since the Guidelines make clear that they should not be relied upon as an assurance that the listed assets were depreciable, the taxpayers were not misled to their detriment and the Government is not estopped from asserting that the expenditures in dispute are not depreciable.

The above shall constitute findings of fact and conclusions of law as required by Rule 52(a), F. R. Civ. P.

Submit order.

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41. Px. 21, p. 54:

33. "Question: Questions often arise as to whether particular expenditures are deductible expenses or are capital expenditures which should be recovered through depreciation. How does this depreciation reform affect the resolution of these questions?

Answer: The depreciation reform does not affect the classification of expenditures as capital or expense. Questions in this area must be resolved on the basis of presently established principles. *The depreciation reform affects only those expenditures which are properly chargeable to capital and recoverable through depreciation deductions.*" (Emphasis added).

IN THE
UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF DELAWARE.

—

CIVIL ACTION NO. 4287

—

ROBERT W. TUNNELL, and
EOLYNE K. TUNNELL,

Plaintiffs

v.

UNITED STATES OF AMERICA,

Defendant

—

CIVIL ACTION NO. 4302

—

JAMES M. TUNNELL, JR. and
MILDRED S. TUNNELL,

Plaintiffs

v.

UNITED STATES OF AMERICA,

Defendant

JUDGMENT.

The Court having considered the evidence and the arguments of counsel, and having entered its opinion, it is in conformity therewith:

ORDERED, that plaintiffs Robert W. Tunnell and Eolyne K. Tunnell have judgment against the defendant for the principal amount of $11,861.36, with interest thereon at six percent according to law from November 19, 1970.

DONE IN OPEN COURT at Wilmington, Delaware, this 9th day of April, 1974.

JAMES L. LATCHUM,
United States District Judge

Presented and approved by:
JAMES M. TUNNELL, JR.,
Attorney for Plaintiffs

Approved as to form by:
BRUCE T. THALL,
Asst. United States Attorney

IN THE
UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF DELAWARE.

—

CIVIL ACTION NO. 4287

—

ROBERT W. TUNNELL, and
EOLYNE K. TUNNELL,
Plaintiffs

v.

UNITED STATES OF AMERICA,
Defendant

—

CIVIL ACTION NO. 4302

—

JAMES M. TUNNELL, JR. and
MILDRED S. TUNNELL,
Plaintiffs

v.

UNITED STATES OF AMERICA,
Defendant

JUDGMENT.

The Court having considered the evidence and the arguments of counsel, and having entered its opinion, it is in conformity therewith:

ORDERED, that plaintiffs James M. Tunnell, Jr. and Mildred S. Tunnell have judgment against the defendant for the principal amount of $12,828.93, with interest thereon at six percent according to law from November 18, 1970.

DONE IN OPEN COURT at Wilmington, Delaware, this 9th day of April, 1974.

JAMES L. LATCHUM,
United States District Judge

Presented and approved by:
JAMES M. TUNNELL, JR.,
Attorney for Plaintiffs

Approved as to form by:
BRUCE T. THALL,
Asst. United States Attorney

JAMES M. TUNNELL, JR., and
MILDRED S. TUNNELL

v.

THE UNITED STATES OF AMERICA,
Appellant

ROBERT W. TUNNELL and EOLYNE K. TUNNELL

v.

THE UNITED STATES,
Appellant

Nos. 74-1675, 74-1678

United States Court of Appeals, Third Circuit.

Argued Feb. 7, 1975. Decided March 11, 1975. As Amended April 23, 1975 (Reported 512 F. 2d 1192, *et seq.*)

Scott P. Crampton, Asst. Atty. Gen., Gilbert E. Andrews, Richard W. Perkins, William A. Friedlander, Tax Div., Dept. of Justice, Washington, D. C., for appellant.

James M. Tunnell, Jr., Morris, Nichols, Arsht & Tunnell, Wilmington, Del., Robert W. Tunnell, Georgetown, Del., pro se and as attys. for other appellees.

Before ADAMS, ROSENN and WEIS, *Circuit Judges.*

OPINION

ROSENN, *Circuit Judge.*

Taxpayers, Eolyne K. and Robert W. Tunnell, and Mildred S. Tunnell and James M. Tunnell, Jr., formed two partnerships to develop and operate two mobile home parks known as "Pot Nets" and "Indian Landing" in Sussex County, Delaware.[1] Third parties lease lots on a

1. Our statement of the facts has been limited to those relevant to this appeal. A fuller version appears in the opinion of the district court. 367 F. Supp. 557 (D. Del. 1974).

long term basis in both parks for the purpose of placing thereon mobile homes for use as summer and weekend dwellings.

Both mobile home parks are situated on land which, in its original state, was part marsh, part cultivated, and part forested. Low-lying marshes separated the wooded and cultivated areas from the open waters of Indian River Bay, and, being soft and wet, were unsuited for either buildings or roads. In order to construct the parks, taxpayers designed and dredged channels, called lagoons, and used the material produced by the dredging to fill the marshland, thus enabling the construction thereon of roads, and recreational and living areas.

Bulkhead lagoons, more aesthetically pleasing than the marshlands, provide a safe and very convenient harbor for the boats of the residents of the parks. The lagoons also provide improved surface water drainage for the flat and low terrain on which the parks were built.

The wooded areas in their original state also were unsuited for construction. Taxpayers therefore thinned out portions of these areas and cleared the remaining land. All of the solid land areas were then graded, shaped, and landscaped for use as home sites, roads, and recreational areas. When completed, the parks featured home sites, private roads, street lights, water and electricity lines, landscaping, and various recreational facilities.

On the partnership tax returns for the years in dispute, taxpayers had depreciated the total cost of constructing the lagoons. Useful lives of ten and twenty years were claimed for the Pot Nets and Indian Landing lagoons, respectively. Taxpayers also had deducted as operating expenses the costs of clearing, grading, landscaping, and staking out the mobile home lots.

The Commissioner disallowed these deductions. Taxpayers paid under protest the taxes allegedly due plus interest, and then brought suit in the district court for a refund. In the district court, they sought to depreciate as capital expenditures the amounts previously deducted as operating expenses in the returns.

The district court held that the lagoons were depreciable, and allowed the depreciation deductions to be based upon the total cost of building the lagoons. The court equated the useful lives of the lagoons with the useful lives of the parks, which it believed the Commissioner had agreed were twenty years. The court also held depreciable over a period of twenty years the costs of clearing, landscaping, and staking out the land because the benefits of these expenditures were pecliar to the operation of the parks. Depreciation deductions for the expenses of grading the land were disallowed because the grading produced benefits which would run with the land after the operation of the parks had terminated. The useful lives of the grading benefits therefore were indeterminate and not depreciable.

The Government appeals. It now concedes that the costs of designing and constructing the lagoons, and of clearing, staking out, and landscaping the land were depreciable. Based on the IRS Depreciation Guidelines, Rev. Proc. 62-21, 1962-2 Cum. Bull. 418, the Government also concedes the useful lives of the lagoons and of the landscaping to be twenty years. The Government argues, however, that the district court erred in calculating the depreciable basis of the lagoons, and in assigning useful lives of twenty years to the clearing, landscaping, and staking out of the land. We find merit in the Government's contentions, vacate the judgment, and remand.

The basic rule, according to Treasury regulations, is that depreciation will be allowed on that sum which will, at the end of the estimated useful life of the depreciable property, equal the cost or other basis of the property less

its salvage value. Treas. Reg. § 1.167(a)-1(a) (1956). Salvage value is the "amount (determined at the time of acquisition) which is estimated will be realizable upon sale or other disposition of an asset when it is no longer useful in the taxpayer's trade or business . . . ." Treas. Reg. § 1.167(a)-1(c)(1) (1956). This rule of depreciation, controversial as it may have been at one time, was approved in Massey Motors v. United States, 364 U. S. 92, 80 S. Ct. 1411, 4 L. Ed. 2d 1592 (1960).

The district court, in allowing taxpayers to depreciate the total cost of designing and constructing the lagoons, apparently assumed that the assets created by these expenditures would have no value at the end of twenty years. Two assets were created: the lagoons themselves, and the material used to fill, grade, and convert the surrounding marshlands into dry usable land. The lagoons, the Government now concedes, will be worthless at the end of twenty years. The fill, however, created additional value in the land, a value having an indeterminate life, and this fill, therefore, is not subject to depreciation.[2] Treas. Reg. § 1.167(a)-2 (1956). We see no reason to disregard this value merely because it is a by-product of the dredging. Indeed, deducting such value in calculating the amount to be depreciated is consistent with the intent of Congress "not to make taxpayers a profit . . . but merely to protect them from a loss." Massey Motors v. United States, *supra*, 364 U. S. at 101, 80 S. Ct. at 1416. We believe, therefore,

2. Taxpayers argue that since the lagoons, having useful lives of twenty years, will fill with the dredged material, the fill also has a useful life of only twenty years, and thus will be worthless at the end of that period.

We do not believe that the record supports the assertion that the lagoons will be filled with the dredged material. Indeed the argument is directly contradicted by the district court's finding, which we believe is supported by the record, that the land improved by the fill will not wear out. 367 F. Supp. at 563.

the proper amount recoverable by depreciation is the total cost of designing and constructing the lagoons less the sum it would have cost the taxpayers to obtain the necessary quantity of fill from their own property, if possible, or elsewhere to grade and convert the marshlands into suitable, dry land for the operation of mobile parks.[3]

The Government argues, however, that since taxpayers by not proving the cost of the land fill and thereby not proving this excess amount, did not meet their burden of proving the amount to which they were entitled as a depreciation deduction. We agree that taxpayers have the burden in a refund suit of proving not only an entitlement to a refund but also the amount of the entitlement. Crosby v. United States, 496 F. 2d 1384 (5th Cir. 1974). Had the taxpayers been aware that this excess amount was to have been in controversy, we would also agree that the taxpayers would not be entitled to any refund for depreciation of the lagoons. Both the deficiency notice [4] and the pretrial order,[5] however, show that the

3. This formulation assumes that the total cost of designing and constructing the lagoons exceeds the cost of the fill. If this assumption proves to be incorrect, taxpayers will not be able to recover any amount in depreciation.

4. The deficiency notice provided in pertinent part:

> The property in this case does not meet any of the requirements necessary for the application of the depreciation deduction . . . . The costs of lagoons that is [sic] being disallowed consisted of the initial dredging of the lagoons. In conclusion, a taxpayer must show clear provision for any deduction claimed and the deduction in this case does not qualify under Section 167, but represents a capital expenditure that should be added to the cost of the land. It is clear that land or any cost that is inextricably associated with land is not subject to the depreciation allowance. The reason for this is that it has a life that is not susceptible to measurement . . . . Therefore, . . . the depreciation deduction is being disallowed.

5. The pretrial order provided in pertinent part:

> (d) . . . Defendant contends that [the expenditures for creating the lagoons] are for permanent land improvements

Government disallowed the depreciation deductions not because the deductions disregarded the salvage value of the land fill, but because the Government regarded the lagoons as inextricably associated with the land and not depreciable at all. Not until the concluding testimony of the last witness did the Government make explicit the theory upon which it now relies. Under these circumstances, we believe it unfair to deny taxpayers their deductions for failure to meet their burden of proof. We believe that, under the circumstances of this case, justice requires that we remand to the district court so that taxpayers may have the opportunity to prove the amount on which depreciation properly may be recovered.[6]

With respect to the deductions for clearing and staking out the land, the district court, under the impression that the Commissioner had agreed to useful lives of twenty years for the parks, equated the useful lives of these improvements with the useful lives of the parks. We find no fault with such equation. An examination of the record, however, discloses that while the Commissioner had agreed that many of the various physical components of the parks had useful lives of no more than twenty years, he had made no such agreement about the useful lives of the parks. To equate the useful lives of the parks with

5. (Cont'd.)

. . . with indeterminable useful lives for which no depreciation or expense deductions are allowable . . . .

* * *

(i) Defendant expects to prove that plaintiffs are not entitled to take depreciation deductions for the cost of the initial dredging of lagoons and permanent land improvements . . . .

6. Since we must remand, we deem it appropriate to note that the Government's brief concedes that taxpayers' costs for designing and laying out the lagoons are depreciable over the useful life of the lagoons. These costs, however, were lumped together with payments for staking out mobile home lots and were not separately established. In view of our holding, a breakdown may be necessary should the district court determine that the useful life of the parks *qua* parks exceeds twenty years.

the useful lives of many of the parks' physical components was error.

Taxpayers argue that the useful lives of the parks were twenty years for two reasons: (1) so many of the physical components of the parks would wear out within twenty years that the usefulness of the parks would likewise terminate;[7] and (2) the value of the parks inextricably was tied to the lagoons whose useful lives the Government concedes to be twenty years.

A review of the record leaves us unclear as to whether taxpayers have carried their burden of proof on either of their contentions. Therefore, we also remand the case to the district court for further evidence and findings on this issue. *See* Hoffman Motors Corp. v. United States, 473 F. 2d 254 (2d Cir. 1973). To be successful on remand, taxpayers must show that the useful lives of the parks inextricably are related to the useful lives of the lagoons or to the sum of the parks' physical components that will wear out within twenty years so that the parks' usefulness *qua* parks thereupon will terminate.

The judgment of the district court will be vacated and the case will be remanded for further proceedings consistent with this opinion.

The parties shall bear their own costs.

7. The physical components that will wear out include water systems, electrical systems, television equipment, streets, street lights, playground equipment, piers, docks, bulkheading, slips, groins, jetties, and swimming pools.

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 74-1675

JAMES M. TUNNELL, JR.,
AND MILDRED S. TUNNELL

v.

THE UNITED STATES OF AMERICA,
Appellant

No. 74-1678

ROBERT W. TUNNELL AND
EOLYNE K. TUNNELL

v.

THE UNITED STATES,
Appellant

PRESENT: ADAMS, ROSENN and WEIS, *Circuit Judges*

ORDER.

Upon consideration of the petition for rehearing and amendment of opinion by the original panel in the above-entitled matter and the answer thereto, it is ORDERED that

The last sentence of the first paragraph on page 5 of the slip opinion will be amended so as to read:

> We believe, therefore, the proper amount recoverable by depreciation is the total cost of designing and constructing the lagoons less the sum it would have cost the taxpayers to obtain the necessary quantity of fill from their own property, if possible, or elsewhere to grade and convert the marshlands into suitable, dry land for the operation of mobile parks.[3]

In all other respects, the petition for rehearing and amendment of the opinion is denied.

By THE COURT:

MAX ROSENN,
Circuit Judge.

Dated: April 23, 1975

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

Nos. 74-1675 and 74-1678

JAMES M. TUNNELL, JR., AND
MILDRED S. TUNNELL

v.

THE UNITED STATES OF AMERICA,
Appellant in No. 74-1675

(D. C. Civil Action No. 4302)

ROBERT W. TUNNELL AND
EOLYNE K. TUNNELL

v.

THE UNITED STATES,
Appellant in No. 74-1678

(D. C. Civil Action No. 4287)

APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF DELAWARE

Present: ADAMS, ROSENN and WEIS, *Circuit Judges*

JUDGMENT.

These causes came on to be heard on the records from the United States District Court for the District of Delaware and were argued by counsel.

On consideration whereof, it is now here ordered and adjudged by this Court that the judgments of the said District Court entered April 9, 1974 be, and the same are hereby vacated, and the causes are remanded to the said District Court for further proceedings consistent with the opinion of this Court. The parties shall bear their own costs.

ATTEST:

THOMAS F. QUINN,
Clerk.

March 11, 1975

Certified as a true copy and issued in lieu of a formal mandate on May 1, 1975.

Teste:

THOMAS F. QUINN

Clerk, United States Court of Appeals
for the Third Circuit

DEPRECIATION

Guidelines and Rules

U. S. TREASURY DEPARTMENT
INTERNAL REVENUE SERVICE
Publication No. 456
Revised August 1964

For sale by the Superintendent of Documents,
U. S. Government Printing Office
Washington, D. C. 20402—Price 30 cents

PART I.—GUIDELINES FOR DEPRECIATION

GROUP ONE: GUIDELINES FOR DEPRECIABLE ASSETS USED BY BUSINESS IN GENERAL

3. *Land Improvements* * ..... 20 years

Includes land improvements † such as paved surfaces, sidewalks, canals, waterways, drainage facilities and sewers, wharves, bridges, all fences except farm fences, landscaping, shrubbery and similar improvements. Includes agricultural land improvements not classified as soil and water conservation expenditures under the Internal Revenue Code of 1954.

Excludes land improvements which are the major asset of a business, such as cemeteries or golf courses. The depreciable life of such land improvements shall be determined according to the particular facts and circumstances.

Excludes land improvements of electric, gas, steam, and water utilities; telephone and telegraph companies; and pipeline, water, and rail carriers. (These improvements † are covered under Group Four.)

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* See Appendix III, Annotations, page 85.

† See Appendix II, Questions and Answers 33 and 75.

No. 75-92

Supreme Court, U.S.
FILED
SEP 10 1975
MICHAEL RODAK, JR., CLERK

In the Supreme Court of the United States

OCTOBER TERM, 1975

ROBERT W. TUNNELL and EOLYNE K. TUNNELL,
PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

ROBERT H. BORK,
Solicitor General,
Department of Justice,
Washington, D.C. 20530.

In the Supreme Court of the United States

OCTOBER TERM, 1975

No. 75-92

ROBERT W. TUNNELL and EOLYNE K. TUNNELL,
PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

The sole question presented in this federal income tax case involves the correct basis for depreciation of canals ("lagoons") dredged by petitioners in connection with their development of two mobile home trailer parks.

These lagoons were used for boat access and mooring and were created for the additional purpose of acquiring fill dirt for converting low-lying marsh-

lands into useable land areas. The district court held that petitioners' entire cost of dredging (about $105,000) should be treated as the depreciable basis of the lagoons (Pet. App. A1-A6). The court of appeals vacated and remanded the case to the district court for further evidence concerning the useful lives of the lagoons (Pet. App. A21-A27). However, it upheld the Commissioner's position that the depreciable cost of the lagoons was the excess of the cost of construction over the market value of the fill dirt (*id.* at A24-A25).

1. Petitioners argue (Pet. 8-9) that the decision of the court of appeals is inconsistent with what they claim to be the uniform administrative practice to apportion the lump-sum cost of two assets on the basis of their respective fair market values. But the rule which they invoke was developed to deal with the different case where two separate assets are purchased for an unallocated lump-sum price, where the assets could have been acquired separately, and where it is apparent that only a part of the lump price is being paid for each of the assets. There, the problem is one of determining what part of the total price is allocable to the cost of each separate asset. As a result, where the allocation is of a negotiated purchase price, it is appropriate to allocate the bases in proportion to the market values of the assets because it can be reasonably assumed that the total price is the sum of the respective market values.

However, this approach is not applicable to this case where the cost of the assets is not derived from a negotiated purchase price but from fixed costs incurred in creating the assets which are unrelated to value. Thus, since petitioners' costs in dredging the lagoons produced two assets—the lagoons and the fill dirt—the value of the fill should be subtracted from the total cost to yield the correct basis of the lagoons.[1]

Indeed, the allocation rule urged by petitioners would conflict with the basic principles of tax depreciation established by this Court in *Massey Motors* v. *United States*, 364 U.S. 92, 107, and in *United States* v. *Ludey*, 274 U.S. 295, 300-301. There, the Court observed that the only purpose of the depreciation deduction is to allow the taxpayer to recover, in the aggregate, an amount which, when added to the salvage value (the amount which can be recovered through resale of the asset), will equal the taxpayer's original cost of acquiring or creating the asset. See also Treasury Regulations, Section 1.167 (a)-1(a). In determining the proper basis for depreciation of the lagoons, the fill has the same relationship to the depreciable property as salvage value, and accordingly must be deducted.

The further admonition in *Massey Motors* (364 U.S. at 101) that "Congress intended by the depreci-

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[1] Treasury Regulations, Section 1.167(a)-5 cited by petitioners (Pet. 8), deals only with the distinguishable case of the lump-sum acquisition of two assets which could have been acquired and priced separately. To the same effect are the two Tax Court memorandum decisions and the revenue ruling relied upon by petitioners (*ibid.*).

ation allowance not to make taxpayers a profit thereby, but merely to protect them from a loss" has pointed application here. As the court of appeals recognized (Pet. App. A24), the fill created additional value in the reclaimed marshland which could be recovered at any time. Thus, if petitioners were permitted to ignore the enhanced value generated by the land fill and to depreciate the entire cost of constructing the lagoons, they would be able to recover a sum in excess of that cost and thereby make an unwarranted profit from their depreciation.

2. Petitioners further argue (Pet. 10-11) that the value of the dirt fill must be measured as of the end of the 20-year useful life of the lagoons. However, their contention is premised upon an incorrect characterization of the decision below as requiring that the fill dirt be treated as the salvage value of the lagoons. The court of appeals held that petitioners' actual cost of acquiring the lagoons was not more than the excess of the total outlay over that part which was reflected in the increased, and nonwasting, value created in the land by the same dredging costs. Thus, the improvements to the marshlands created through the use of the fill dirt was treated as increasing the salvage value of the land and not the lagoons.[2]

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[2] Moreover, petitioners cannot complain (Pet. 10) properly that the court of appeals permitted an alternative use of the cost of obtaining the required amount of fill dirt from some other source. This accomodation was for petitioners' benefit and was a recognition of the possibility that the quantity and quality of fill dirt required to effect the improvements to the marshy land areas could have been purchased elsewhere at a lesser cost than dredging their own land, so that only the lesser amount should be deducted from the portion of the dredging costs assigned as the depreciable basis of the lagoons.

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

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Solicitor General.

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